

Funding Innovations for California Infrastructure: Promises and Pitfalls

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SUMMARY

The ability of California's state and local governments to provide and maintain adequate levels of civil infrastructure has been strained by sustained, rapid population growth and a variety of fiscal constraints including voters' reluctance to tax themselves for public works. Governor Schwarzenegger recently unveiled an ambitious ten-year plan for rebuilding the state's infrastructure. Consistent with his promise not to raise taxes, the plan relies instead on various forms of debt financing, earmarking of existing revenues, and increased federal contributions. It calls for new user fees and private equity investments in transportation and aims to save costs through reforms in transportation contracting. This proposal and others draw from the toolkit of "innovative financing" that has been gaining popularity with governments nationwide as they aim to stretch the infrastructure dollar. In *Funding Innovations for California Infrastructure: Promises and Pitfalls*, a study funded by the USC Keston Institute for Infrastructure, Ellen Hanak and Kim Rueben examine the extent to which new public and private sources can be mobilized to build for the future. With a focus on transportation and water resources, they point out the pitfalls of relying too heavily on additional bond financing or general-source revenues and highlight the potential for strategies that align the benefits of new investments with the costs of provision.

FUNDING INNOVATIONS FOR CALIFORNIA

In planning for the future, California should weigh the costs and benefits of different funding options and consider both the short and long-term implications of new investment strategies. Policy-makers should keep the following criteria in mind as they make decisions.

1. Innovations that can raise funds while aligning the incentives of infrastructure customers with efficient use of the system should be encouraged.

In general, this strategy implies reserving general funding sources to invest in areas where the benefits are diffuse or where there are clear social goals or positive externalities that make user fees inappropriate, such as public education. In some sectors, this means going back to some of the original principles of infrastructure finance. For example, supplementing gasoline tax revenues with sales tax revenues for highway funding is a move in the wrong direction. New technologies have created opportunities to improve upon the gas tax. Transportation authorities worldwide are experimenting with electronic toll collection to charge drivers for miles traveled. Fees can be varied by road type and by the level of congestion, two elements that affect the costs of road use. Even if drivers are reluctant to pay tolls to use existing roads, these tools can be used to build new lane-miles. California was an early leader in the modern movement toward "value-pricing" and high-occupancy toll (HOT) lanes, with several successful experiments in Southern California since the mid 1990s, but the state has been a laggard more recently.

By the same token, using general obligation debt to fund new water supply, rather than revenue bonds paid for by service contracts, decouples cost from use and does not provide incentives to use water resources efficiently. An appropriate model is the State Water Project (SWP), one of the pillars of California's investment program in the "golden era" of the 1950s and 1960s. The SWP is entirely funded by water agencies that benefit from the investment.

2. Financing tools matter.

California needs to assess the proper role for debt financing versus pay-as-you-go activities, recognizing that borrowing ultimately must be paid back. Although state infrastructure investments in the late 1990s and early 2000s were largely funded with general obligation (GO) bonds, the tens of billions of dollars slated to appear on the ballot in 2006 as part of the Governor's plan would in all likelihood push the overall debt ratio well above 6 percent, a commonly-used warning post. High debt ratios can lower a government's bond ratings, leading to higher cost of capital. They also encumber state revenues, forcing society to make trade-offs with other spending priorities. In later years, the Governor's plan also calls for bonding a portion of gas tax revenues to finance transportation projects. It is one thing to engage in debt financing when the project creates a new revenue stream such as a toll; it is another to expect to pay for increased spending with existing revenue streams. These considerations favor the adoption of an infrastructure plan that relies on new funds, tied where possible to the services provided.

3. *Fee-raising authority should be aligned with the regulatory responsibilities of local agencies.*

When local governments are required to provide services, they need to be able to raise fees for this purpose, even when benefits are not directly tied to the fees incurred. For flood control, there has been a growing recognition that the current programs are woefully inadequate. Improvement in this area might entail changing limitations introduced by Proposition 218, a constitutional amendment that mandated majority votes for general taxes and extended Proposition 13's supermajority requirement to local assessments and non-specific fees.

4. *Responsibilities and costs should be tied to those making planning decisions.*

The state now faces liability for flood control, yet local governments make the land-use decisions that put residents and businesses at risk. Legislative or constitutional changes that shift the primary liability to local governments and require full disclosure of flood risks could help rectify this imbalance.

5. *There is a role for increased public-private collaboration, but private projects won't replace government planning and action.*

Private equity financing has potential at the margin, but it is not a widespread solution. When increasing the role of the private investments, it will be important to understand the contracting risk/return tradeoff and who is ultimately liable to pay for unsuccessful projects. Opportunities to leverage projects using private resources are greatest when the benefits can be used to repay the costs and the return on investment is well defined. There is also room for more flexible contracting arrangements with private entities, using design-build or design-build-operate contracts. In this new model, now used successfully in many states, the public agency awards a single, fixed-fee contract for the majority of the design and construction services. These contracting agreements can help the public sector take advantage of new technology, coordinate incentives in contracts and speed up job completion, and they may save costs. However, these relationships are relatively untried in California's transportation sector. To be successful, it will be important to integrate them into the Caltrans system and to get the support of current employees.

There may be a silver lining in California infrastructure funding politics. If the public is averse to raising general taxes, this can open up opportunities for more use of specific fees, where people can see the direct benefits of the services they are paying for. At the same time, a movement toward fees for service can improve the incentive structure. Explaining the need for fees or increased revenues to pay for services offers a different path than relying on statewide GO bonds. This shift could open up more opportunities for regional fees to fund regional projects, more closely tied to the beneficiaries. By aligning costs and benefits, California can help satisfy its current and future infrastructure needs while protecting the ability of future generations to make their own spending choices.

ADDITIONAL RESOURCES

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THE USC KESTON INSTITUTE FOR INFRASTRUCTURE

The USC Keston Institute for Infrastructure is a nonpartisan research organization established at the University of Southern California to help California and the nation address critical infrastructure issues. The Keston Institute supports the formulation of infrastructure policies and practices that will improve the livability of California communities, ensure the economic well-being of its citizens, and promote environmental sustainability.

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